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Memorandum

To: John Morgan, Comptroller of the Treasury
Dave Goetz, Commissioner of Finance and Administration
Steve Adams, Treasurer
Riley Darnell, Secretary of State

From: Richard Gurley, Legislative Research Analyst
Holly Presley, Legislative Research Intern

Date: 5/6/2003

Re: Economic Report to the Governor

Each winter, the University of Tennessee's Center for Business and Economic Research (CBER) publishes its annual *Economic Report to the Governor*, as required by TCA §9-4-5202. This report provides estimates of economic growth, including growth in nominal personal income, based on the Tennessee econometric model. TCA §9-4-5202 also requires the State Funding Board to comment on the "reasonableness" of CBER's estimate of nominal personal income growth. Each spring, the Office of Research evaluates CBER's estimate in light of evolving economic trends and recent outside forecasts to assist the funding board.

Overall Conclusion: based upon a review of data and other information available to the Office of Research, CBER's projections of personal income growth for fiscal year 2004 appear reasonable.

CBER Compared to Other Forecasts

Growth in Tennessee personal income has traditionally tracked growth in U.S. gross domestic product (GDP) very closely. Exhibit 1 shows relative actual and projected changes in both of these measurements from the first quarter of 1997. The left side of the graph compares actual Tennessee and U.S. data from previous years. The right side of the graph compares CBER's estimate of nominal personal income growth in Tennessee to an estimate of U.S. GDP growth calculated by averaging projections from the Federal

Reserve Bank of Philadelphia and Wachovia. Though CBER projects Tennessee personal income growth to lag U.S. GDP growth in late 2002 and exceed it in early 2003, its estimates for Tennessee personal income growth in fiscal year 2004 closely follow outside estimates of U.S. GDP growth.

Exhibit 1: Relative Changes in US GDP and TN Personal Income

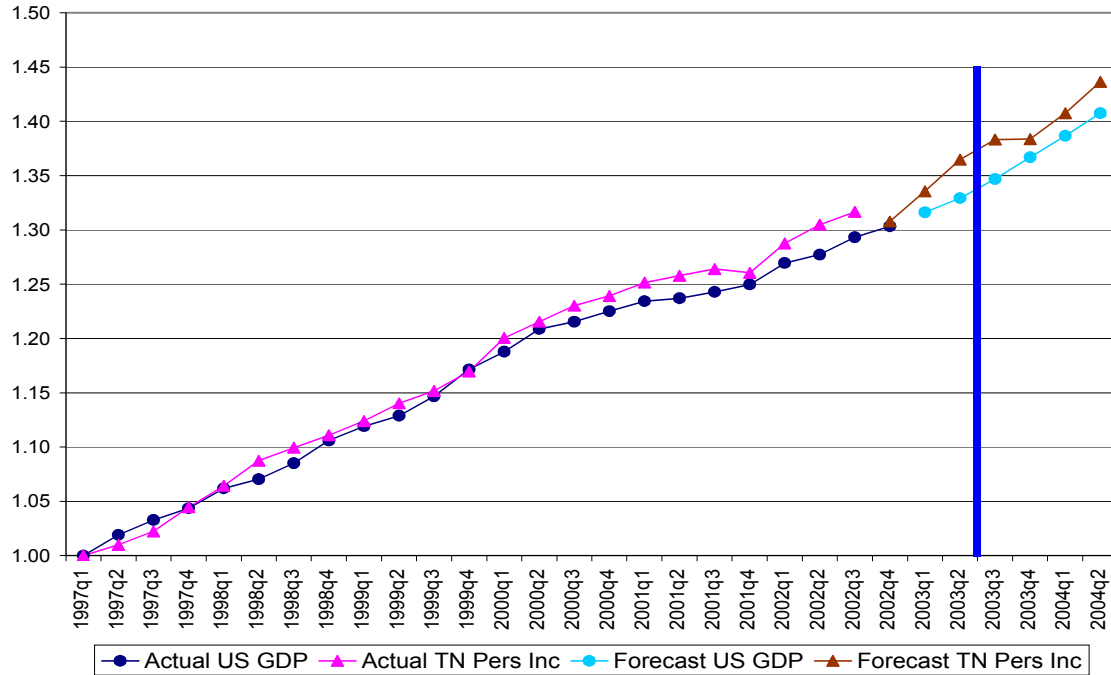
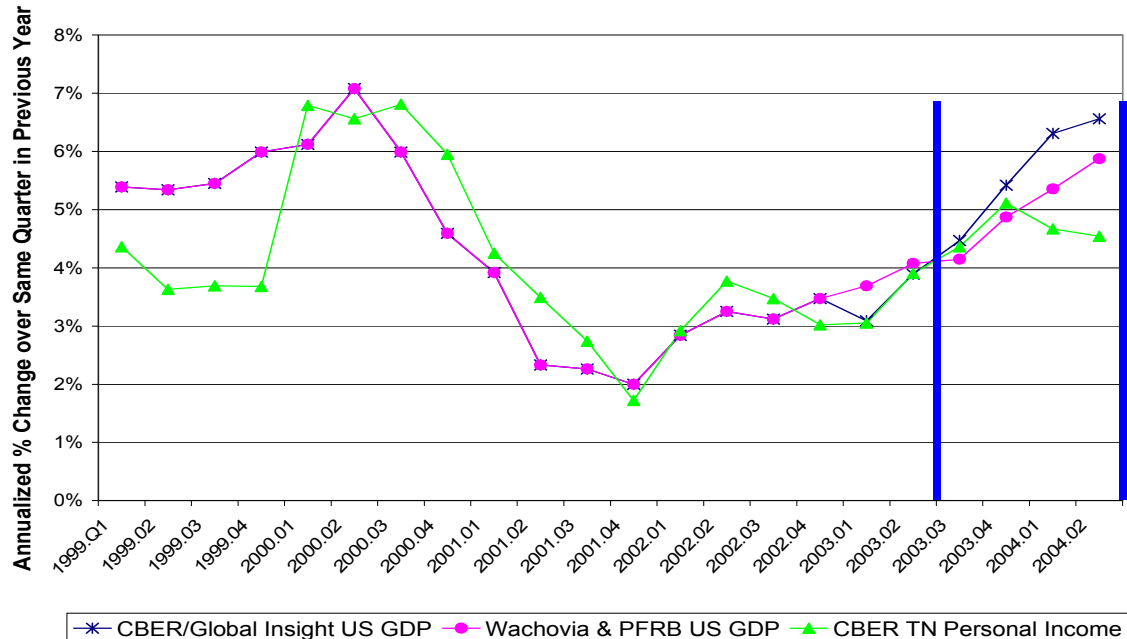


Exhibit 2: Changes in US GDP and Tennessee Personal Income



Sources: Department of Commerce, Bureau of Economic Analysis; UT CBER, *An Economic Report to the Governor of the State of Tennessee*; Federal Reserve Bank of Philadelphia; and Wachovia.

Recent and Potential Macroeconomic Influences

International influences

The quick and decisive conclusion of the recent war in Iraq will promote economic growth in the coming year. However, problems in Syria, North Korea, and other nations could emerge to undermine that growth. On April 14, Philadelphia Federal Reserve Bank President Anthony Santomero noted, "It's far too soon to declare the global situation as having been stabilized and the U.S. economy back on track."¹

The International Monetary Fund (IMF) predicts real world output to grow faster than real U.S. GDP this year and next. However, U.S. GDP growth will outpace growth in other advanced economies, which are the prime U.S. trading partners and consume most Tennessee imports. Stagnant economic conditions in major trading partners could drag economic growth in Tennessee. Exhibit 3 shows Tennessee exports to various regions in 2002 and real GDP growth projections for 2003 and 2004 for various countries and regions.

Exhibit 3: International Economic Growth Projections

| | Tennessee Exports in 2002 | | Growth in Real Output | |
|------------------------------|---------------------------|---------|-----------------------|------|
| | Value of Exports | % Total | 2003 | 2004 |
| World Output | | | 3.2% | 4.1% |
| U.S. | | | 2.2% | 3.6% |
| Canada | \$3,946,700,000 | 34% | 2.8% | 3.2% |
| Latin America | \$1,799,300,000 | 15% | 1.5% | 4.2% |
| Euro Zone | \$1,659,500,000 | 14% | 1.1% | 2.3% |
| Emerging | | | | |
| Asia | \$1,479,900,000 | 13% | 6.0% | 6.3% |
| UK | \$633,000,000 | 5% | 2.0% | 2.5% |
| Japan | \$599,600,000 | 5% | 0.8% | 1.0% |
| Australia | \$223,500,000 | 2% | 3.0% | 3.7% |
| Middle East | \$197,000,000 | 2% | 5.1% | 4.9% |
| Other | \$1,082,800,000 | 9% | | |
| TN Importers Weighted Growth | | | 2.7% | 3.6% |

Sources: U.S. Census Bureau, Foreign Trade Division, "Total U.S. Exports (Origin of Movement) via Tennessee," and International Monetary Fund, *World Economic Outlook*, April 2003.

Consumer spending

Nominal consumer spending, which accounts for over two-thirds of U.S. GDP, grew a robust 4.5 percent in 2002,² fueled in large part by mortgage refinancings. Refinancings increased household wealth by \$150 billion in 2002 and another \$65 billion in the first quarter of 2003.³ However, with interest rates poised to rise in coming months, the refinancing boom is largely played out, and Americans are increasing their savings rates to compensate for poor investment performances. The national savings rate grew from 2.3

¹ CNN.com, "Fed: Economy in delicate transition,"

http://money.cnn.com/2003/04/14/news/economy/fed_santomero.reut/index.htm, April 14, 2003.

² U.S. Department of Commerce, Bureau of Economic Analysis, "National Data: Selected NIPA Tables," Table 1.1. Gross Domestic Product, April 2003.

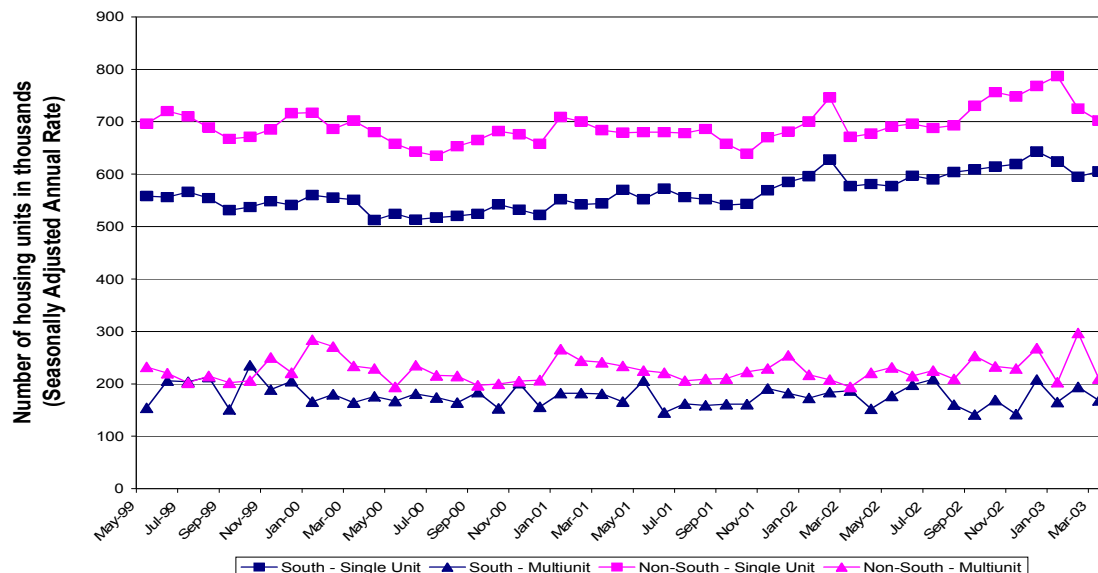
³ Justin Fox, "The Case for Optimism," *Fortune*, March 17, 2003.

percent in 2001 to 4.3 percent in January and may be headed higher still. Though a high savings rate promotes long-term economic stability, it comes at the expense of consumer spending and will dampen economic growth in the short run.⁴

Residential construction

The housing market has been one of the pillars of economic growth in recent years. Exhibit 4 shows building permits issued since May 1999. These data indicate new home construction in both the South and the rest of the nation should remain strong in the coming months, but many economists have predicted declines from record levels experienced recently.

Exhibit 4: Building Permits for New Privately Owned Housing Units



Source: U.S. Census Bureau, "New Privately Owned Housing Units Authorized by Building Permits in Permit-Issuing Places," <http://www.census.gov/const/bpsa.pdf>, April 21, 2003.

Business investment

Sharp declines in business investment have been the primary reason for slower economic growth over the past two years—business spending actually shrank 5.2 percent in 2001 and another 5.7 percent in 2002.⁵ Strong growth in business spending does not appear likely in 2003. On April 10, 45 percent of CEOs participating in the Business Roundtable expected to cut jobs this year. Only 9 percent expected to increase the number of employees in their companies. Furthermore, 27 percent of firms participating in the Business Roundtable plan to cut capital spending in the next six months while only 18 percent plan to increase it.⁶ However, the quick resolution to the war in Iraq has reduced economic uncertainty and has set the stage for renewed growth in business investment later this year and in early 2004.

⁴ Justin Fox, "The Case for Optimism," *Fortune*, March 17, 2003.

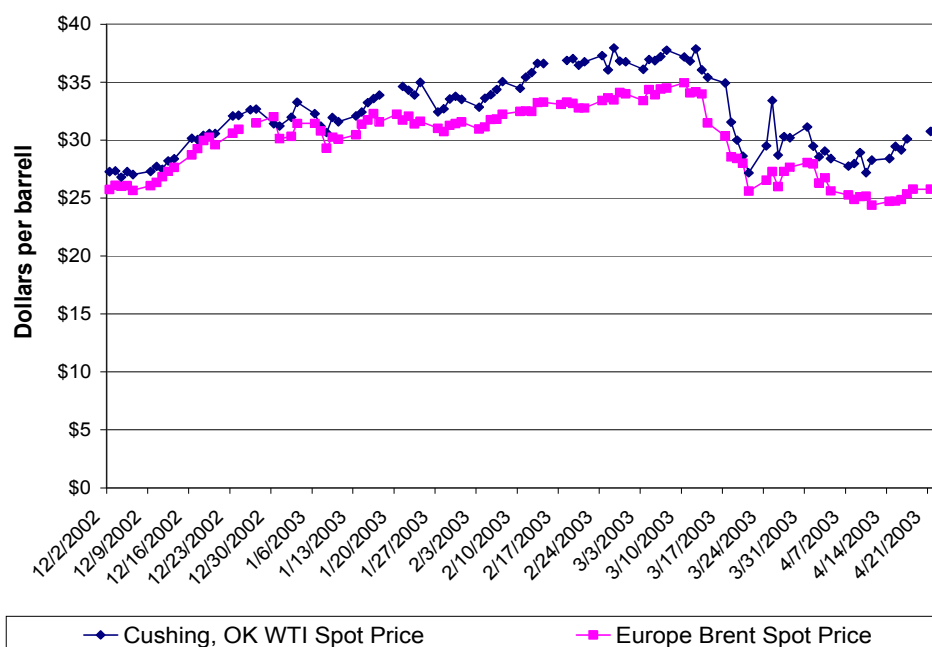
⁵ Justin Fox, "The Case for Optimism," *Fortune*, March 17, 2003.

⁶ Greg Ip and Jon Hilsenrath, "For Economy, Peace May Be Answer—Consumer Confidence is Up, Oil Prices, Layoffs Down; But CEOs Stay Pessimistic," *The Wall Street Journal*, April 11, 2003, p. A3.

Oil prices

Though increased technology and the growing relative importance of the service sector have reduced the U.S. economy's susceptibility to spikes in the oil markets, oil prices still exert significant influence on it and have dampened economic growth in recent months. International political events are the primary culprit for higher oil prices. Major energy companies halted operations in Nigeria in the midst of ethnic clashes, cutting oil production there almost 40 percent. A nationwide strike in Venezuela cut oil exports from that country from about 3.1 million barrels a day to less than 0.6 million. Since then, exports have rebounded to about 2.5 million barrels.⁷ Exhibit 5 shows international oil prices from December 2, 2002 to April 21, 2003.

Exhibit 5: International Oil Prices



Source: U.S. Department of Energy, Energy Information Administration, "U.S. Petroleum Prices," April 23, 2003.

Barring any new political upheaval in major oil-producing states, oil prices are poised to decline further and remain relatively low. Worldwide oil production rose to a record 80.3 million barrels a day in March.⁸ Production levels in Nigeria and Venezuela are returning to traditional levels, and Iraq's capacity, still largely intact, will further increase supplies. Some analysts have speculated that a new Iraqi government will not join OPEC, reducing the organization's capacity to shore up prices as production increases worldwide in the coming year. Many industry analysts have predicted oil prices to settle around \$25 a barrel in the coming months. Economists have projected that a \$10 drop in the price of a

⁷ Neela Banerjee, "Oil's Pressure Points," *The New York Times*, April 13, 2003, p. 1.

⁸ "Crude Oil Falls as OPEC Faces Glut," *The Los Angeles Times*, April 11, 2003, p. C3.

barrel of oil is the equivalent of a \$55 to \$100 billion tax cut for U.S. businesses and consumers.⁹

Federal budget

Congress is poised to pass a significant tax cut package this session. The cumulative impact will likely fall between \$350 billion, the amount passed by the Senate, and \$550 billion, the maximum established in joint budget resolution. Both totals are well below the \$726 originally proposed by the administration.¹⁰ Tax cuts phased in during 2003 and 2004 should provide some short-term economic stimulus. The tax cuts also appear unlikely to produce large federal budget deficits. The Congressional Budget Office projects that even if the proposed \$726 billion tax cut were fully implemented, the federal budget deficit would equal only three percent of GDP in federal fiscal year 2004, and would decline thereafter.¹¹ As a result, federal budget deficits are unlikely to exert significant upward pressure on long-term interest rates.

A Word of Caution

Though macroeconomists take many variables into account and use sophisticated quantitative methods to shape their forecasts, major economic disruptions are often difficult to project. In spring 2001, many economists were projecting a mild slowdown in economic growth later that year followed by more robust growth in subsequent years. However, since that time the terrorist attacks of September 11, accounting scandals at major U.S. corporations, and spikes in oil prices driven by unrest in Iraq, Nigeria, and Venezuela have conspired to keep U.S. economic growth well below projections that appeared reasonable in early 2001. Tennessee has not been immune to these national trends. Though Tennessee now appears poised for moderate economic growth in 2003 accelerating in 2004, many unforeseen circumstances could disrupt that scenario.

⁹ Nelson D. Schwartz, "Why Oil Prices Will Fall," *Fortune*, March 17, 2003; Anna Bernasek, "Get a Move On!" *Fortune*, April 14, 2003.

¹⁰ David Francis, "US Administration Alters its Tax-Cut Pitch," *Christian Science Monitor*, April 21, 2003, p. 20.

¹¹ Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004*, March 2003, Table 1.